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LGL Partners Investment Brief

The US federal debt ceiling—short-term theatrics but a long-term problem

July 2011

Summary

The political sideshow continues unabated in Washington as the semi-arbitrary "deadline" of August 2, 2011 to raise the federal debt ceiling is around the corner.

Words like "default" and "downgrade" choke the airwaves while politicos intone that the "full faith and credit" of the US is at imminent risk. How serious is this issue? What should investors do? What is the outlook on the market in the short-term? This LGL Investment Brief looks to sort fact from bluster.

We feel a US downgrade is a real possibility, but a default is not the most likely scenario. Volatility will be high in the short term, but the results need not be especially disruptive. Longer-term fiscal issues will remain, no matter what the resolution is next week. Globally, fundamentals remain important, and they are mixed.

Analysis

First, this is a serious issue. But, it is a much more serious than the first-order posturing coming out of Washington. The issue of raising the debt ceiling, now likely requiring 11th-hour heroics, etc., is a sideshow. The debt ceiling has never been a hard and fast restraint on spending. It was $330 billion in 1940 and has been raised over 100 times[1] since then, including 10 times over the past 10 years, during which the limit has more than doubled. It has gone up by 45% just since 2007. Clearly, raising the ceiling is now old-hat. Why the acrimony now?

Two things are different this time.

1) The 2010 Congressional election that changed the balance of power in the Congress and infused a strident strain of libertarianism among the freshman class. So, not only are Republicans in power in the House, where spending is born, the composition of their caucus has veered further to the right. Moreover, with the Presidential election looming next year, a parlous game of chicken is unfolding before our eyes, as Republicans are doing their best to make the Democrats look bad, while seemingly unmindful of the damage they are doing to themselves. Conversely, the Democrats are unwilling to do anything (make large cuts) to disgruntle voters this close to the election, or cause a contractionary impact on the market.
2) The dollar amounts of the debt, the deficit, and the debt ceiling are now historically high, and that is a different issue.

While raising the debt ceiling should be perfunctory, the sideshow has attracted the market's and the world's attention to something that could have been sidestepped a while longer. Now, the NRSROs (ratings agencies) have been forced to weigh in, and that as rattled nerves (as it should.) S&P has suggested that there is a 50% likelihood of the US being downgraded in the next several months. But, this didn't have to happen (yet). Washington has brought this issue to a boil this summer, but it could have simmered a while longer.

At the moment (Friday, July 29, 2011), there are two primary "solutions" being put forward, but this changes daily, and these could well be added to the discard pile.

[1] Budget of the United States Government: Historical Tables, Fiscal Year 2010, http://www.gpoaccess.gov/usbudget/fy10/hist.html

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Competing approaches

The Boehner (Republican) Plan
The original Boehner proposal would reduce budget deficits by a total of about $915 billion between 2012 and 2021 according to the Congressional Budget Office[2] (CBO), largely through imposing caps on discretionary spending. In return, it would provide for increasing the debt limit by about $2.5 trillion, subject to the approval of additional cuts over the next decade.[3]

The Reid Plan (Democrat) Plan
According to the CBO, this plan would produce aggregate savings of $2.2 trillion over the same period of time through discretionary spending caps, elimination of waste, and caps on new funding for war-related activities. It would provide for increasing the debt limit by about $2.7 trillion. Unlike the Boehner Plan, this one would get the country past the 2012 election.

We are not in the position to "endorse" either of these plans, but we do hope that Washington gets serious, because this problem is not going away, even if it recedes from view upon a successful resolution of the current fracas. On the horizon are more severe fiscal imbalances. Reid's and Boehner's numbers simply aren't big enough.

The real problem

We have touched upon this subject before (see "LGL Partners Investment Brief—The cost of dollars"). The chart below shows something about to happen that hasn't been seen in a very long time, and hasn't been seen ever in the contemporary economy. The level of US debt will exceed the level of GDP, and the trajectories of both of these series suggest that the divergence will be pronounced and long-lasting. Also of note is the fact that GDP has been below trend for some years, and debt slightly above trend (although the latter tends to swing more widely.)

[2] The Congressional Budget Office is a federal agency within the legislative branch of the United States government that provides economic data to Congress. It is generally well-respected and seen as a non-partisan source of analysis.

[3] The Congressional Budget Office, *Letter to the Honorable John A. Boehner*, July 27, 2011. (http://www.cbo.gov/ftpdocs/123xx/doc12341/HouseBudgetControlActLetterJuly27.pdf)

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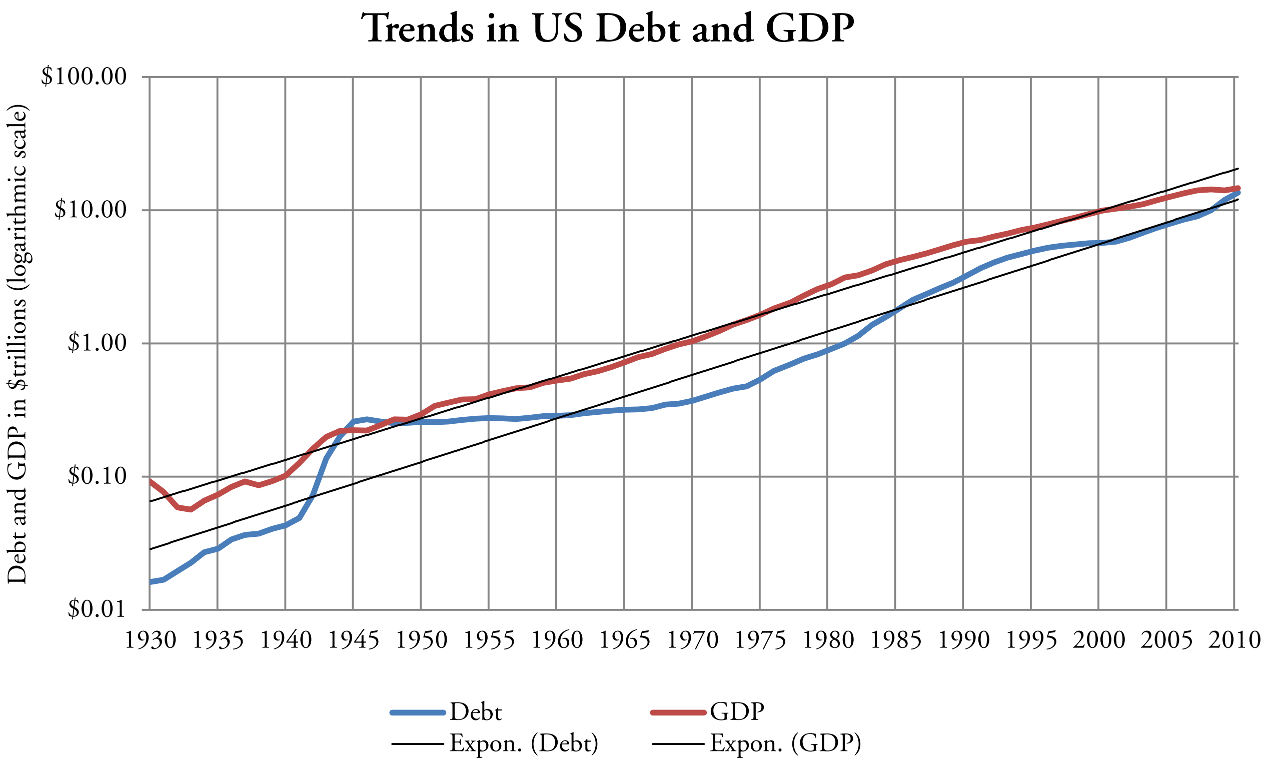


Source: Congressional Budget Office and the Federal Reserve Bank of St. Louis

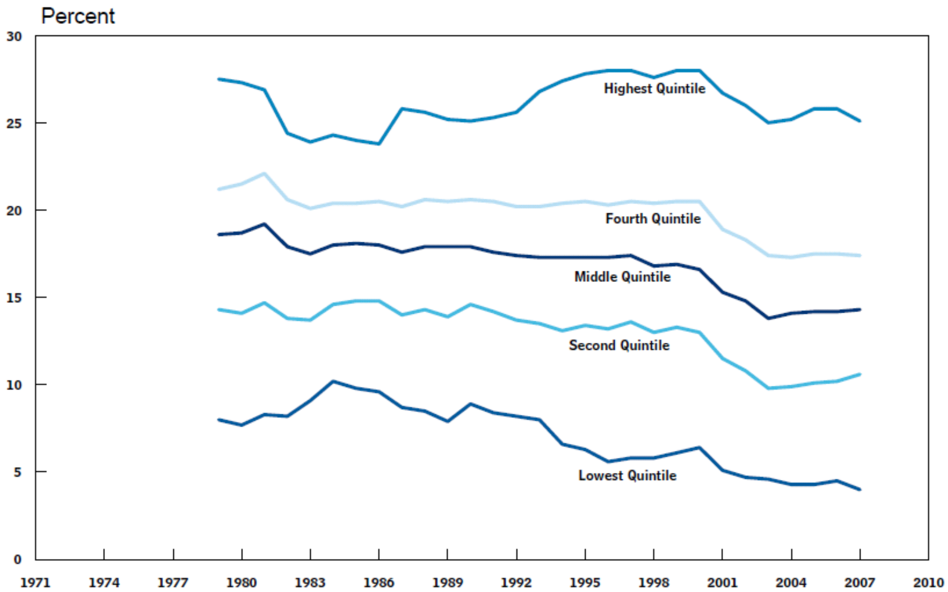
The US is not likely to grow its way out of this problem. While GDP growth since WWII has averaged over 6%, the conditions that have supported that level of growth aren't likely to be seen in the immediate future. Most analysts expect US GDP growth over the next decade to be between 3% and 4%.

GDP Growth in the Decade Ending:

2010	2000	1990	1980	1970	1960	1950	1940
3.9%	5.4%	7.3%	9.9%	6.8%	5.8%	10.6%	1.1%

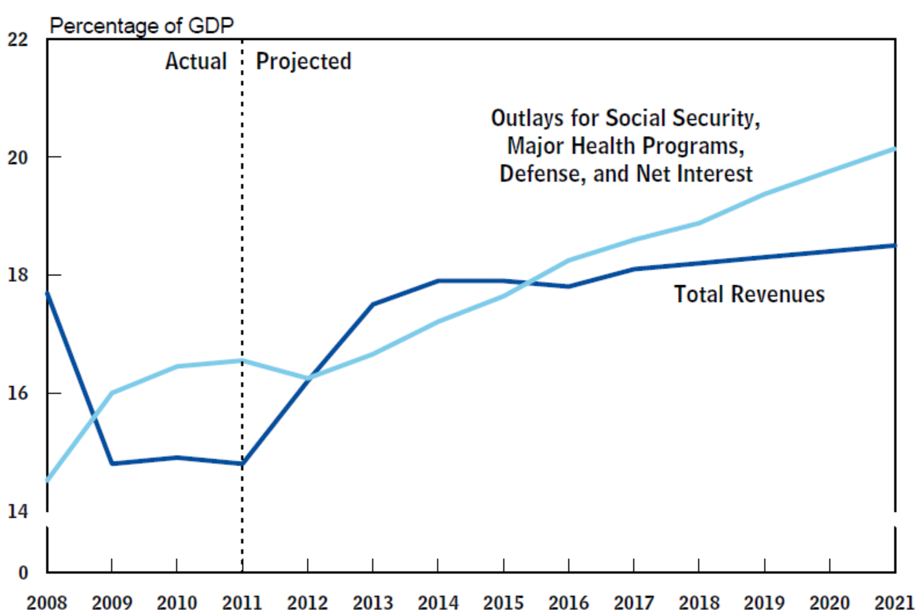
Source: Federal Reserve Bank of St. Louis

According to the CBO, revenues at the federal level have averaged about 18% over the past 40 years, subject to fluctuations, but without a sustained trend either way. In part, this is due to relatively steady tax revenues. While tax rates on average are lower than they have been, for the highest wage earners, they have remained within a narrow band.



Source: Congressional Budget Office

Where do the revenues go? According to the CBO, many categories of spending have declined over time. Defense has dropped to under 4% of GDP, from 7.3% in the 1970s, as have other categories of discretionary spending. However, it is important to note that discretionary spending and defense spending are around 20% of all federal outlays. The majority of federal spending is non-discretionary, and that has been growing and looks to continue growing. The following chart, also from the CBO shows the constraints the country is likely to face in the future.



Source: Congressional Budget Office

By 2015, at current levels of spending, non-discretionary obligations and net interest will exceed all revenues. When this happens, the raising the debt ceiling will become academic. The following chart shows the dollar impact of the trends in the preceding chart. The savings Boehner is projecting over 10 years is less than the average budget deficit in *one* year.

CBO's Estimate of the President's Budget

	Actual	Estimates										
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Revenues	2,163	2,229	2,544	2,899	3,212	3,442	3,635	3,818	3,994	4,179	4,382	4,597
Outlays	3,456	3,655	3,708	3,800	3,976	4,191	4,476	4,687	4,896	5,200	5,483	5,756
Total Deficit	-1,294	-1,425	-1,164	-901	-764	-748	-841	-870	-902	-1,021	-1,101	-1,158
Debt	9,019	10,389	11,661	12,660	13,516	14,359	15,292	16,254	17,250	18,364	19,558	20,806

US debt will be increasing, in absolute terms, per capita terms, and as a percentage of GDP. To put the current situation in perspective, of 169 countries surveyed by the IMF[4], only 13 have a higher ratio of gross debt to GDP than the US. Those 13 include Greece, Lebanon, Jamaica, Eritrea, Italy, Grenada, Iceland, and Ireland, many of which have been in the news recently on account of shaky fiscal foundations.

Market impact

The issues addressed above are not the proximate cause of the short-term Washington crisis. A debt downgrade may be justified on the grounds of the long-term debt story, but a downgrade now could arise either due to some sort of default (still not the most likely situation) and/or a perception that the US government cannot make hard decisions. What has happened and what is likely to happen in the markets?

Fixed income and credit

First of all, a downgrade need not be catastrophic in financial terms. Japan lost its AAA rating in 1998 and Canada followed. The Yen has been one of the strongest currencies in the world since 1990 and has enjoyed extremely low interest rates for years (supporting the highest debt to GDP in the world). While Japan's debt-deflation trap and equity doldrums aren't something the US should seek to emulate, Canada rebounded from its downgrade event. Its currency and financial markets have been strong.

As the deadline approaches, there has been no strong evidence of forced selling among fixed income or cash managers and investors. The yield curve has remained very steady, and indeed, is flatter than it was last month. However, CDS prices on US debt have risen over the past few days.

4 International Monetary Fund, World Economic Outlook 2010

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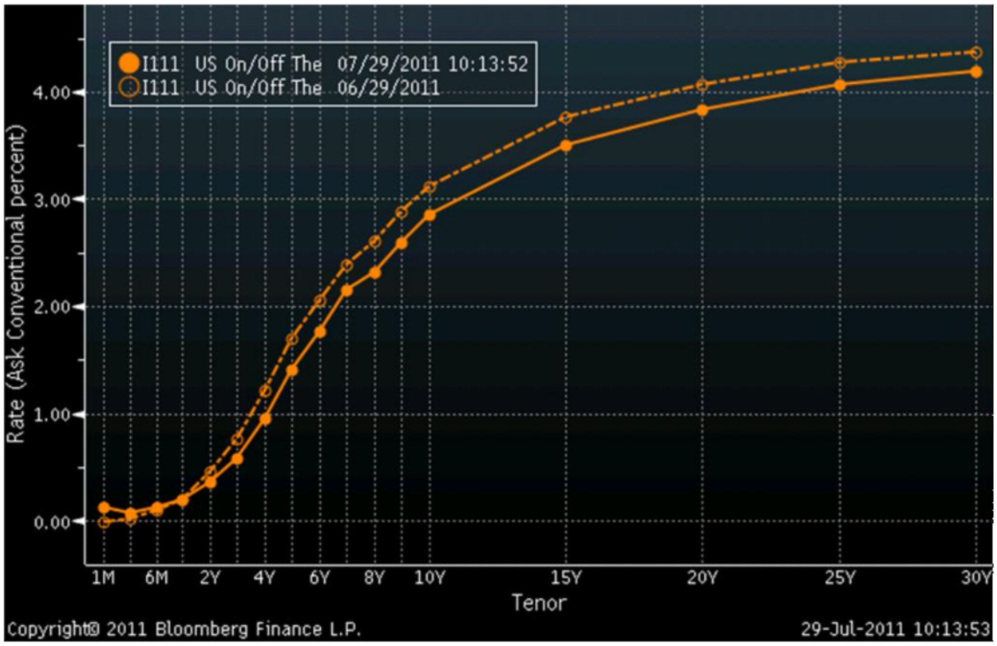

If there is a downgrade or a lingering impasse in the negotiations, analysts project a 25-50 bps rise in long rates. Cash and very short-term borrowing will be more attractive, although there has recently been a pronounced move up at the very short end of the curve. Forced rebalancing or sales by short term fixed income managers are not likely because a US downgrade to AA would not conflict with most of their mandates.

Some major banks might be downgraded due to their systemic importance and the reliance upon the implicit support of the US, such as JPM. AAA-rated insurance companies are also on watch. Spread-based products (such as high yield, investment grade, convertible bonds, bank debt, mortgages) could be sold off as the market requires higher interest rates to compensate for this uncertainty. If there is a sell-off in higher quality bonds, it may be a buying opportunity, although investors should do their homework.

Sub-investment-grade debt and emerging market debt could also decline as spreads widen. However, sovereign bonds from some countries with stronger balance sheets could benefit.

At the end of the day, there simply aren't that many alternatives to US Treasurys. As seen below, all the major AAA alternatives, combined, don't come close to the $9 trillion of AAA debt held by the public. Just the Chinese holdings of US Treasurys exceed all other available sovereign AAA debt. In fact, counterintuitively, after an initial jump at the long end of the curve, US Treasury yields may actually fall.

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AAA-rated Alternatives to US Treasurys

	($ billions)
U.S. AAA Rated Corporate	$36
Canadian Sovereigns	$383
French Sovereigns	$1,400
German Sovereigns	$1,300
United Kingdom Sovereigns	$1,300
Australia Sovereigns	$161
Denmark	$120
New Zealand (Aaa/AA+)	$40
Total	**$4,740**

Source: Barclays Global Treasury Index

Downward pressure on rates on Treasurys would come from weaker than expected economic fundamentals and/or de-risking. Once the situation in Washington recedes, attention may return to the problems in Europe, and Treasurys, even at AA, will look good.

Municipals

The municipal market is likely to be impacted, but not in a single direction. Municipal to Treasury yield ratios could rise above 100% on medium and longer-term maturities. Fannie Mae, Freddie Mac and the other GSEs could be downgraded, as could FHA-backed state housing agencies. Municipal debt linked to federal support (highways, power plants and the like) or states where the federal government is crucial to the local economy may be downgraded, such as Virginia and Maryland. Also, entities depending on Medicaid matching payments, as well as those entities that rely on market access to refinance variable rate demand obligations are concerns.

Pre-refunded municipals bonds (those escrowed with Treasurys) could be hurt, but AAA rated municipal bonds might increase price given they would be higher rated than pre-refunded alternatives. High quality revenue bonds issued by public authorities should not experience problems, and realistically, there is not any appreciably higher likelihood of high quality municipals defaulting due to recent events, so long-term holders should stay the course.

Equities and other risk assets

That said, volatility will probably be elevated over the next few weeks and a temporary, small move down in equities might occur. The correction would be larger for emerging market equities, some commodities and small capitalization equities. But, precious metals should climb even more. If negotiations truly turn sour and the markets don't see a short-term agreement, this reaction with be amplified. In the medium term, equity fundamentals remain solid.

Conclusion

A true "default" next week is not the most likely scenario, but some sort of credit disruption becomes more likely by the day. Whatever happens probably won't be known until we get much closer to the deadline. More likely, a band-aid compromise is effected, making the next round of negotiations more fraught, and the eventual reckoning more severe. As long as no major elected officials (who are seriously included in the conversation by party chiefs) seem to have the gravitas or vision to focus attention on the severity of the

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problem, this is all we can hope for. At the same time, that is a long-term bearish proposition for the US as it drives home the lack of wherewithal in Washington to get things done or ensure a competitive economic climate over the long run.

Yet, the market is still not panicking as much as it might. A downgrade of US debt may well be on the horizon. Whatever promises or dissembling comes from House and Senate leaders, the NRSROs are not beholden to voters; rather, they report to the market. And S&P and its peers have been telegraphing their concerns as transparently as they ever do. However, in the beauty contest of sovereign debt, US Treasurys, whether they are AAA or not, especially when contrasted with the debt of virtually any nation save Germany, will continue to be attractive. There simply aren't alternatives.

Rates may rise somewhat in the near term, but probably not much. This will probably be more pronounced for longer-dated borrowing. Credit spreads may rise in the short term, and if they do, this could be a short term buying opportunity for high quality corporate debt, where balance sheets are much healthier than what is seen at the sovereign level. Equity volatility will likely stay elevated for a while also, but there, too, fundamentals are sound, and quality large caps remain a safer area of the market.

LGL Partners invests globally, and while there may be some longer-term issues, US corporate balance sheets are healthy and US equities remain a core component of our balanced global asset allocation. But, mindful of the current situation in Washington and longer-run fiscal constraints, we suggest tactical positions in non-USD equities, commodities, alternative strategies, and international fixed income.

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